

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-4120

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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P/5

NO. 77-4120

SIDNEY R. SOLOMON AND BEATRICE SOLOMON,
Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

ON APPEAL FROM A DECISION OF
THE UNITED STATES TAX COURT

REPLY BRIEF FOR APPELLANTS

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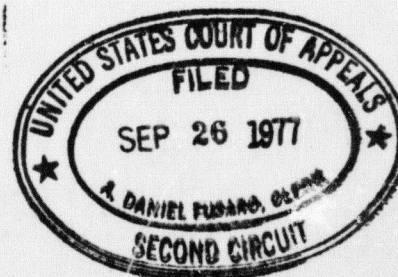


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PRELIMINARY STATEMENT

In 1968, the taxpayers (the appellants in this case) exchanged their stock in the Quinn Manufacturing Company (Quinn) and the Detroit Bolt and Nut Company (Detroit) for stock in Whittaker Corporation (Whittaker). Because some of the Whittaker

stock was represented by a right to receive additional stock, and because actual shares of stock were issued pursuant to that right in 1971, the Commissioner has attempted to impose a tax under section 483 of the Internal Revenue Code of 1954 (the Code). That section creates an element of unstated interest in "deferred payments" which do not include a sufficient rate of stated interest. As demonstrated in the taxpayers' opening brief (T.Br. pp. 9-16), however, there was no deferred payment in this case. Under the rule that the substance rather than the form of a transaction is controlling for tax purposes, the right to receive additional stock contained in the merger agreement was a stock interest in Whittaker. Thus, the taxpayers received their stock in 1968, and there was no deferred payment when the actual shares of stock were issued in 1971.

It was also demonstrated in the taxpayers' opening brief (T.Br. pp. 16-25) that, under section 1223(1), the taxpayers are considered to have held the stock received in 1971 from before the date of the exchange. Section 483, however, presupposes a payment received after a sale or exchange. Under well-recognized rules of statutory construction, the more specific provision, section 1223(1), controls and establishes that there was no deferred payment, so that section 483 by its terms does not apply.

The Commissioner does not take issue with the fundamental rule of statutory construction that specific Code provisions take precedence over general Code provisions in the case of conflict. Instead, he argues that section 483 is not governed by that rule. The Commissioner's argument, however, is contrary to the decision in Fox v. United States, 510 F.2d. 1330 (3rd Cir., 1975), which establishes that section 483 is a general Code section whose scope is limited by this rule. Since the Commissioner has been unable to distinguish the Fox case, the taxpayers submit that it controls the outcome of this case, and that the Tax Court should be reversed.

ARGUMENT

- I. THE COMMISSIONER HAS FAILED TO REFUTE THE TAXPAYERS' POSITION THAT THERE HAS BEEN NO DEFERRED PAYMENT WITHIN THE MEANING OF SECTION 483 BECAUSE THEIR ENTIRE STOCK INTEREST IN WHITTAKER WAS RECEIVED IN 1968, AT THE TIME OF THE REORGANIZATION.

In 1968, the taxpayers exchanged their stock interests in Quinn and Detroit for an equivalent stock interest in Whittaker. However, because the parties were unable to agree on the value of their respective interests, the taxpayers only received part of their interest in Whittaker in the form of actual shares of Whittaker stock. The balance of their interest was represented by a right to receive additional Whittaker stock. Thus, the merger of Quinn and Detroit into Whittaker was a classic example of a contingent stock reorganization. Such reorganizations are a common means of resolving valuation

problems, and they have received the expressed approval of both the Commissioner and the courts. Contingent stock reorganizations satisfy the "solely for voting stock" requirement for qualification as tax-free reorganizations because the right to receive additional stock is, as a matter of economic substance, the stock that it represents.

Since the right to stock received in 1968 is considered in substance to be Whittaker stock, the issuance of actual shares of stock in 1971 pursuant to that right did not add anything to the taxpayers' interest. They had owned the stock since 1968, and the issuance of the shares was merely a replacement of the formal indicia of that stock interest. Since it is axiomatic that tax consequences follow the substance rather than the form of a transaction, the taxpayers did not receive a deferred payment in 1971 within the meaning of section 483.

The Commissioner acknowledges that, under the authority of Carlberg v. United States, 281 F.2d 507 (8th Cir., 1960) and James C. Hamrick, 43 T.C. 21 (1964), acq. 1966-1 C.B. 2, the right to additional stock received as part of the reorganization in 1968 was the stock in Whittaker that it represented (C.Br. p. 14). He argues, however, that the right is only stock for purposes of the reorganization provisions of the Code, and that it is not stock when other provisions are applied to the same transaction. This argument is incompatible with the decision in Carlberg and the cases which have

followed it. In Carlberg, the Court gave four separate and independent reasons for its holding, only one of which involved a consideration of the purpose of the reorganization sections. A completely separate reason was the economic substance of the rights received. The Court concluded that "the substance of the certificates equates only with stock . . ." (281 F.2d at 520). This conclusion was not tied in any way to the reorganization provisions, but was instead an evaluation of the true economic substance of the plaintiff's rights.

The cases which have followed Carlberg confirm that its holding has significance beyond the reorganization provisions. In James C. Hamrick, supra, the Tax Court relied on Carlberg and held that a right to receive stock was equivalent to stock. The transaction in Hamrick, however, was not a reorganization; it was a contribution to capital. In John P. Gawler, 60 T.C. 647 (1973), aff'd 504 F.2d 425 (4th Cir. 1974), the issue was whether a loss was ordinary or capital under section 165. The Tax Court relied on both Hamrick and Carlberg in concluding that the loss was capital. It did not recognize any restrictions on the applicability of the rules announced in those cases.

The Commissioner also argues that the right to receive additional stock was an evidence of indebtedness within the meaning of section 483(c)(2). This argument, however, is contrary to the stipulations of the parties and the findings of the Tax Court. The Commissioner has stipulated, and the

Tax Court found, that the acquisition of Detroit and Quinn by Whittaker qualified as a tax-free reorganization under section 368(a)(1)(B) of the Code. That section defines a reorganization as follows:

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). (Emphasis added.)

The merger of Quinn and Detroit into Whittaker would not have satisfied the requirements of this section if the taxpayers had received anything but voting stock from Whittaker. Thus, the merger would not have qualified if the right to receive additional Whittaker stock had been an evidence of indebtedness within the meaning of section 483(c). Since the transaction does satisfy this statutory definition, the right to receive additional stock cannot be an evidence of indebtedness, or anything else other than Whittaker stock.

Finally, the Commissioner argues that the right to receive additional stock was not Whittaker stock because it did not carry with it the right to vote or receive dividends. The Commissioner's argument, however, is contradicted by his own published ruling position in Rev. Rul. 66-112, 1966-1 C.B. 68 and Rev. Rul. 67-90, 1967-1 C.B. 79, and by his acquiescence in the Hamrick case. In both of the rulings and in the Hamrick case,

rights to receive stock were held to be stock as a matter of economic substance despite the fact that they did not confer the right to vote or receive dividends.

In Carlberg, the Court expressly held that the right to receive stock is the stock that it represents, even if it does not possess all of the traditional attributes of stock ownership:

...While some of the provisions of the merger agreement and of the Certificate may seem to impinge upon what are regarded as customary and normal attributes of ownership of stock, we regard these as compelled by the practical necessities of the situation here and as not affecting or diminishing the inherent stock character of what the taxpayer received or as granting her different or additional non-stock rights...
(281 F.2d at 519.)

Similarly, the taxpayers' right to receive Whittaker stock was, in substance, stock in Whittaker even though the taxpayers did not have the right to vote or receive dividends.

The most fundamental attribute of stock is that it represents an equity interest in the issuing company. The right received by the taxpayers in 1968 possessed this attribute and, under the authority of Carlberg and Hamrick, that right was stock in Whittaker. Since the taxpayers' entire stock interest in Whittaker was received in 1968, there was no deferred payment to which Section 483 can apply. Accordingly, the Tax Court should be reversed.

- II. THE COMMISSIONER HAS NOT REFUTED THE TAXPAYERS' ARGUMENT THAT SECTION 483 CONFLICTS WITH THE REORGANIZATION PROVISIONS, AND THAT THE REORGANIZATION PROVISIONS MUST TAKE PRECEDENCE UNDER THE RULE OF STATUTORY CONSTRUCTION THAT GENERAL STATUTES MUST YIELD TO SPECIFIC PROVISIONS IN THE CASE OF CONFLICT.

The acquisition of Quinn and Detroit by Whittaker qualified as a reorganization under sections 354(a)(1) and 368(a)(1)(B) of the Code. Accordingly, it is governed by a comprehensive and specific set of Code provisions. Section 354(a)(1) provides that the taxpayers recognized no gain or loss on the exchange, and section 358(a)(1) provides that the taxpayers' basis in their Quinn and Detroit stock carries over into the Whittaker stock received in the exchange. As shown in the taxpayers' opening brief (T.Br. p. 16), this treatment extends to the stock issued in 1971 pursuant to the right to receive additional stock. Finally, section 1223(1) provides that the taxpayers are considered to have held their Whittaker stock, including the stock received in 1971, from the time they originally acquired their stock in Quinn and Detroit.

The application of section 483 to this transaction would be in direct conflict with the tax treatment of qualifying reorganizations. Section 483 can only apply if a payment is received at least six months after an exchange. Section 1223(1), however, provides that the taxpayers are considered to have held the stock issued pursuant to the right to receive additional stock from before the date of the exchange. Clearly,

there can be no deferred payment within the meaning of Section 483 if all of the taxpayers' Whittaker stock is considered to have been held from before the exchange.

The Commissioner argues that both sections 483 and 1223(1) can apply to this transaction because the policies behind the provisions are different. The Commissioner's argument is based on the fact that the reorganization provisions were enacted to govern transactions in which there is a continuity of ownership interest, while section 483 was enacted to govern transactions in which there has been a deferred payment. This argument, however, does not respond to the conflict between the express terms of the two statutes. Moreover, instead of supporting the Commissioner's position, these different policies underscore the conflict between section 483 and the reorganization provisions.

The reorganization provisions were enacted to specify the tax treatment of transactions in which there is a continuity of proprietary interest. Qualification as a reorganization reflects the fact that after the exchange, the parties still own the same underlying investment in income producing property that they owned before the reorganization. Reg. § 1.368-1(b). By contrast, section 483 was enacted to curb abuses inherent in those sales of property in which the payment of part of the purchase price is deferred. The imposition of a tax under section 483 reflects the fact that at least six months after a sale or exchange, one of the parties received something that he did not already own. Clearly, the same transaction cannot satisfy both the

continuity of interest requirement for qualification as a reorganization and the deferred payment requirement of section 483. Since the Commissioner's stipulation confirms that the acquisition of Quinn and Detroit by Whittaker qualified as a reorganization, it follows that it satisfies the continuity of interest requirement and that there was no deferred payment within the meaning of section 483.

The Commissioner relies on the statement in the majority opinion in Jeffers v. United States, 556 F.2d, 986 (Ct. Cl. 1977) that there is no conflict between section 483 and the reorganization provisions because the reorganization provisions are concerned with what is issued, while section 483 is concerned with when the issuance occurs. The effort by the majority in Jeffers to resolve this conflict cannot be reconciled, however, with section 1223(1). That section, like section 483, specifically addresses the question of when stock is deemed to have been acquired. Because each section would treat the same event as having occurred at a different time, they cannot both be applied.

The Commissioner asserts that there is no conflict between section 483 and the reorganization provisions because sections 354 and 368 do not specifically prohibit the recognition of income other than "gain". He also argues that an ambiguous sentence in the technical explanation of an exception to section 483 demonstrates that Congress intended to apply section 483 to transactions in which gain is not recognized. These arguments, however, reflect a misunderstanding of the taxpayers' position.

The taxpayers do not argue that section 483 is inapplicable because section 354 provides that no gain was recognized in the exchange. The taxpayer's position is that section 483 is inapplicable because section 1223(1) specifically provides that all of the Whittaker stock received during the course of the reorganization is considered to have been held from before the date of the exchange. As a result, there was no deferred payment, and section 483 by its own terms does not apply. The Commissioner's argument simply does not respond to the taxpayers' position in this case.

The Commissioner insists that section 483 does not conflict with the reorganization provisions because the interest element of the stock issued in 1971 is severable from the rest of that stock. However, unless the stock is a deferred payment within the meaning of section 483, it does not contain any element of interest. Since the basic issue before this court is whether the Whittaker stock issued in 1971 amounted to a deferred payment, it is irrelevant that the interest element of a deferred payment may be severable.

Throughout his presentation, the Commissioner has relied heavily on statements in the statute and the legislative history to the effect that section 483 applies "for purposes of this title". Those statements, however, do not support the Commissioner's position. Section 483(a) reads in full as follows:

(a) AMOUNT CONSTITUTING INTEREST.--
For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as

interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract. (Emphasis added.)

Although Congress clearly wanted section 483 to have broad impact, it was only intended to have such impact on deferred payments to which the section otherwise applies. This language does not expand the meaning of "deferred payment" beyond the express terms of section 483. Thus, until it is established that the 1971 issuance of Whittaker stock was a deferred payment, the broad preliminary language of the section, like the severability of interest, is irrelevant.

It is significant that section 1223, the application of which has been conceded by the Commissioner in this case, begins with the same broad language as is found in section 483. Applying the Commissioner's own reasoning, section 1223(1) should govern this transaction to the exclusion of section 483.

The Commissioner has failed in his efforts to demonstrate that the application of section 483 to this transaction is not in direct conflict with section 1223(1). Accordingly, section 483 cannot be applied in this case under the fundamental rule of statutory construction that, in the event of a conflict between two Code sections, the general Code section must yield in application to the more specific Code provision.

Fox v. United States, supra, confirms that section 483, as a general Code section, is subject to this rule. In that case, the Court refused to apply section 483 to a transaction governed by the more specific rules contained in sections 71 and 215 despite the fact that section 483, by its literal language, applied to the transaction. The reasoning in the Fox case is applicable here. In the face of the conflict between sections 483 and 1223(1), section 483 must yield to the more specific terms of section 1223(1).

The Commissioner does not argue that the Fox case was incorrectly decided. Instead, he argues that it is distinguishable from this case because the transaction in that case involved the surrender of marital rights, and the surrender of marital rights is not a sale or exchange. The Commissioner's argument, however, does not address that part of the Fox case which is relevant to this case. The significance of the Fox case is its holding that section 483 must yield in application to more specific code sections. Even if the Commissioner were correct, he has merely posed an alternative ground upon which the Fox case could have been decided. This does nothing to diminish the significance of the Third Circuit's actual holding.

The Commissioner's argument that there was no exchange in the Fox case is, therefore, irrelevant. It is erroneous as well. In the Fox case, the District Court expressly held that the wife's relinquishment of her marital rights was an exchange.

This finding was not altered by the Third Circuit. Moreover, the District Court's holding is consistent with the decision of the Supreme Court in Davis v. United States, 370 U.S. 65 (1962), which indicates that a wife's relinquishment of her marital rights is an exchange.

The Commissioner has relied heavily on the majority opinion in Jeffers v. United States, supra. However, the majority in the Jeffers case did not consider the Fox case. Instead, they incorrectly distinguished that case on the ground that, since the taxpayer's wife would have recognized ordinary income in any event, section 483 would not have applied because of the exception contained in section 483(f)(3). However, this point, like the Commissioner's argument that there was no exchange, merely poses a possible alternative ground for the Court's decision, and does not diminish the significance of the Court's actual holding. Moreover, like the Commissioner's exchange argument, this distinction is factually and legally incorrect. The taxpayer in the Fox case was the husband, not the wife, and he stood in the place of the purchaser (510 F.2d at p. 1332, footnote 5). The purchaser is entitled to an interest deduction under section 483 regardless of whether that section would have applied to the seller by virtue of section 483(f)(3). Thus, the Commissioner's reliance on the Jeffers case, like his other arguments, does not diminish the significance of the Fox case.

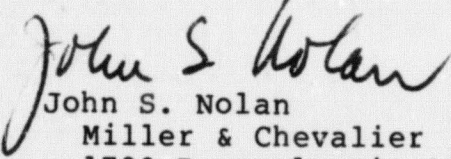
The Fox case establishes that section 483 cannot be applied in the face of a conflict with a more specific Code

provision. That case reached the correct conclusion, and it is indistinguishable from the present case. Accordingly, section 483 can not be applied to this case.

CONCLUSION

The Internal Revenue Code provides a precise pattern of tax treatment for qualifying reorganizations. The courts and the Service have repeatedly held that these provisions are applicable to contingent stock reorganizations identical to the one in issue in this case. These authorities clearly preclude the application of section 483 to the Whittaker stock issued in 1971. The Commissioner has shown this Court nothing which would support a contrary conclusion. Accordingly, the decision of the Tax Court should be reversed.

Respectfully submitted,


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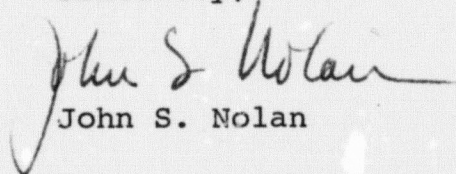
Re: Sidney R. Solomon et. al., v.
Commissioner of Internal Revenue

Docket Number 77-4120

Dear Sir:

Enclosed are ten copies of the appellant's reply
brief in the above captioned case.

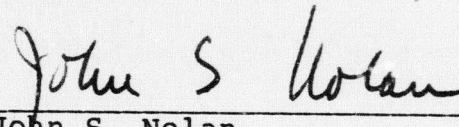
Sincerely,


John S. Nolan

CERTIFICATE OF SERVICE

I hereby certify that two copies of this Brief were served on F. Arnold Heller, attorney for the Appellee, on September 22, 1977. Service was accomplished by certified mail, with postage prepaid, sent to the following address:

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